California State Controller's Review of the Proposed Hollywood Special Reorganization Comprehensive Fiscal Analysis

State Controller
Kathleen Connell

KATHLEEN CONNELL
Controller of the State of California

May 9, 2002

Mr. Larry J. Calemine
Executive Officer
Local Agency Formation Commission
for Los Angeles County
700 North Central Avenue, Suite 350
Glendale, CA 91203

Dear Mr. Calemine:

The State Controller's Office has completed a review of questions raised by the City of Los Angeles regarding the Comprehensive Fiscal Analysis prepared by your Commission for the proposed Special Reorganization of Hollywood. A report of the review and findings is enclosed.

My audit staff is available to consult with you on the details of our review and findings, at your request.

Sincerely,

KATHLEEN CONNELL
State Controller

CALIFORNIA STATE CONTROLLER'S OFFICE REVIEW

OF THE PROPOSED HOLLYWOOD

SPECIAL REORGANIZATION

May 9, 2002

Table of Contents

Executive Summary 1

Review Findings

City Issue 1 3

City Issue 2 13

City Issue 3 16

City Issue 4 18

EXECUTIVE SUMMARY

Background

A proposal was presented to the Los Angeles County Local Agency Formation Commission (LAFCO) for the special reorganization of the Hollywood area of the City of Los Angeles (City). A special reorganization includes the detachment of territory from a city or city and county and the incorporation of that entire detached territory as a city.

The executive officer of LAFCO prepared a comprehensive fiscal analysis (CFA) for the proposed incorporation using three alternative boundaries called special reorganization areas (SRA) in accordance with the requirements of *Government Code* Section 56800. The CFA identifies SRA 3 as the boundary recommended by LAFCO. This is the boundary originally proposed by the applicant less the territory south of Melrose Avenue. The CFA was published on March 6, 2002.

Government Code Section 56801 allows any interested party to ask LAFCO to request that the State Controller's Office review specified elements of the CFA with regards to the accuracy and reliability of the information, methodologies, and documentation used in the analysis. Within 45 days of receiving a request, the Controller is required to issue a report to the executive officer of LAFCO.

On April 5, 2002, the City submitted a request to LAFCO that the State Controller's Office review four issues. The State Controller's Office received the request on April 8, 2002. The four issues are:

1—Based on the reserve levels of cities of comparable size and the expenditures those cities make from those reserves, does the CFA provide a comparable reserve, and will that reserve permit a new city to meet the typical expenditures made by those other cities from their reserves?

2—Does the CFA accurately assess the fiscal impact on the City of Los Angeles?

3—Does the CFA accurately address the impact on other agencies, such as Los Angeles Unified School District ('LAUSD'), Los Angeles Community College District ('LACCD'), and the County of Los Angeles?

4—Does the CFA's calculation of revenue neutrality accurately reflect the fiscal impacts the City will realize at the end of the transition or service contract period?

Findings

1—The State Controller's Office has determined that there is no authoritative basis for determining a "sound financial management" level of reserves. However, the State Controller's Office has also determined that the CFA has incorrectly determined that the new Hollywood city would have positive general fund reserve balances. The CFA incorrectly adds a $10 million loan and a $10 million service reduction to the calculation of reserves to make them positive rather than showing them as alternatives to address the negative reserve balance in all boundary alternatives proposed for the new Hollywood city. For the boundary alternative recommended in the CFA, excluding the loan and service reductions, the reserves would be between a negative 6.24% and a negative 17.52%.

This lack of positive reserves raises a serious concern regarding the fiscal viability of the proposed new Hollywood city. In addition, several cost items in the CFA were calculated incorrectly and could further increase the level of negative reserves.

Finally, the CFA indicates that reserves will grow and compound each year. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA which indicates that the reserves for the new Hollywood city will increase is unreliable.

2—The State Controller's Office determined that the negative general fund reserve level of the proposed new Hollywood city would be increased because of the misapplication of the *Gonsalves* rule. This rule prohibits a county from charging general overhead costs of operation of the county government when providing services under contract to a city. The CFA incorrectly assumed that this rule would apply to charges by the City of Los Angeles for services provided to the new Hollywood city.

3—The State Controller's Office determined that the CFA did not address the fiscal impact of the proposed new Hollywood city on either the Los Angeles Unified School District or Los Angeles Community College District. However, it was not required to do so.

4—The State Controller's Office determined that the City of Los Angeles has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.

REVIEW FINDINGS

CITY ISSUE 1

The City raised the following issue in its request to LAFCO:

"Based on the reserve levels of cities of comparable size and the expenditures those cities make from those reserves, does the CFA provide a comparable reserve, and will that reserve permit a new city to meet the typical expenditures made by those other cities from their reserves?"

The City noted a number of adverse fiscal impacts that may result if the level of reserves are not sufficient for the operation of the new Hollywood city. Specifically, the City states:

> The City believes that the projected reserve levels are insufficient and that the following fiscal impacts are likely:
>
> a. A decrease in services beyond the level stated in the CFA;
>
> b. An increase in taxes or fees in the new city after incorporation;
>
> c. An increased risk to the remaining City of Los Angeles budget, as the new city may default on payments to the City (e.g. debt, service contracts, mitigation payments) and thereby potentially cause adverse service level impacts to the remaining City. A similar concern has been raised in the case of the San Fernando Valley special reorganization effort by Moody's Investor Service, and to the extent that this issue is significant to the Hollywood special reorganization, it should be factored into the findings of the CFA.

The City identified eight concerns to support its position that the CFA did not provide for a sufficient level of reserves for the reasonable operation of the proposed new city. These concerns are:

> **City Concern 1**: The level of projected reserves for the new Hollywood city should be higher.

City Concern 2: The loss of documentary tax revenues and service reductions for the new city upon incorporation, including the transition period, are not adequately addressed.

City Concern 3: The CFA has not adequately addressed how the new city will be able to achieve service reductions of 4.5% to 7.6%.

City Concern 4: The CFA does not adequately address the shortfall the new city would experience that results from the proposed operating costs exceeding available discretionary funds.

City Concern 5: The CFA contains inaccurate costs for election, contract administration, and transition activities.

City Concern 6: The CFA incorrectly represents contract administration costs as a function of the size of the new city and not workload.

City Concern 7: The CFA fails to account for start-up costs.

City Concern 8: The CFA provides insufficient detail regarding the allocation of revenues and expenditures for each proposed boundary.

ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 1

City Concern 1

The City notes the positive reserve level in the CFA for each of the proposed boundaries, but states that sound financial management requires that the reserve level be much higher. The City states that the CFA assumes a level of fiscal stability for the new Hollywood city greater than that of comparably-sized cities. Specifically, the City states:

> The CFA adopts a structural reserve level ranging from 0.85% to 2.87% for SRA1; 2.6% to 7.95% for SRA2; and 0.53% to 2.53% for SRA3. The CFA assumes accumulation of all reserves over a three-year period to achieve these reserve levels. Other cities of comparable size to the Hollywood area maintain reserve levels between 15% to 25%. The CFA has assumed a level of fiscal stability in the proposed new city greater than that of comparably-sized cities without a basis for doing so.

<u>State Controller's Office Analysis and Response to City Concern 1</u>: The State Controller's Office has determined that no authoritative basis exists to determine what constitutes a "sound financial management" level of reserves.

However, the State Controller's Office also concludes that the CFA analysis regarding fiscal viability of the proposed Hollywood city is based on an inappropriate methodology. The CFA notes that the positive general fund reserves are only possible if the new Hollywood city receives a $10 million loan **and** if services are reduced by $10 million in each year subsequent to the transition period. These proposals should have been listed as alternatives to address the negative reserves rather than as part of the comparison between revenues and cost required for a CFA. As a result, the reserve balances for all boundary proposals have negative balances. For the CFA-recommended alternative, excluding the loan and service reduction, the reserves would be between a negative 6.24% and a negative 17.52%.

This lack of positive reserves causes a serious concern regarding the fiscal viability of the proposed new Hollywood city. In addition, the State Controller's Office notes elsewhere in this report that some of the CFA calculations were inaccurate and could increase the level of negative reserves.

The State Controller's Office reviewed the level of reserves for 38 cities of comparable population with the proposed Hollywood city, as reported in the *Cities Annual Report* filed with the State Controller's Office for fiscal year 1998-99. This research found the cumulative level of general fund balances, unreserved and undesignated, as a percentage of general revenues, ranges from a negative 14% to a positive 107.6%. The average level of reserves was 14.3%. Although these percentages vary widely, they show that the negative general fund reserves based on CFA data for the proposed new Hollywood city are significantly below the average level of reserves of comparably sized cities.

Finally, the CFA indicates that reserves will grow and compound each year. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA which indicates that the reserves for the new Hollywood city will increase is unreliable.

City Concern 2

The City expressed its second concern as follows:

> The CFA has not addressed how the shortfall caused by the loss of documentary transfer tax revenues will be handled during the transition. The CFA finds the new city would lose immediately upon incorporation 2.0% to 2.8%, depending on the boundary alternative, of its general fund revenue as a result of the reduction in documentary tax levy. It assumes that the City would correspondingly reduce the cost of services provided to the new city after the transition period. CFA at 6, 39.
>
> The loss of documentary transfer taxes is associated with the ability of the new city to charge the tax upon its change in status from a charter city to a general law city. The change occurs with the effective date of the incorporation, not the end of the transition period. Therefore, the $10 million reduction will be necessary immediately upon incorporation, not 18 months later.

State Controller's Office Analysis and Response to City Concern 2: The State Controller's Office concludes that the CFA correctly addressed the loss of documentary transfer tax revenues to the general fund in the projected budgets for the three proposed boundary alternatives for the new Hollywood city. However, the CFA incorrectly assumes that the mitigation payment should be computed based upon the revenue lost by the City instead of the revenue that would accrue to the new Hollywood city. Thus, the mitigation payment is overstated and the reserve level is understated by $3.6 to $4.4 million, depending on the SRA selected by LAFCO. This would not be sufficient to change the negative reserves discussed under ISSUE 1, City Concern 1.

Government Code Section 11911 allows the board of supervisors of any county to impose a documentary transfer tax at the rate of $0.55 for each $500 of property value in excess of $100. A city within a county that has imposed the documentary transfer tax may impose the tax at a rate of one-half the county amount. If the city tax is imposed at a rate of up to one-half the county rate, there is a credit against the county tax for the city tax. If the city tax is greater than one-half the county tax, no credit is granted against the county tax.

As a charter city, the City has imposed a documentary transfer tax rate in the amount of $2.25 for each $500 of property value in excess of $100. As a general law city, the new Hollywood city is limited by an uncodified section of the *Government Code* to imposing the documentary transfer tax at a rate of one-half of $0.55, or $0.275, per every $500 of property value in excess of $100.

Consequently, the new Hollywood city will receive between $502,000 and $612,000 depending upon the SRA selected by LAFCO. In effect, the new Hollywood city's citizens will receive a tax reduction of between $3.6 and $4.4 million each year.

Finally, the County of Los Angeles will lose between $502,000 and $612,000 as part of the requirement to share its documentary transfer tax with the new Hollywood city. While this revenue loss is not subject to mitigation, the effect on the County of Los Angeles has not been included in the CFA.

City Concern 3

The City expressed its third concern as follows:

> The CFA has not adequately addressed how the revenue shortfalls will be handled after the transition. The CFA states that the new city would be required to achieve overall reductions of 4.5% to 7.6%, depending on the boundary alternative, in the cost of its services. Further that in the absence of a cash advance to the new city by the City of Los Angeles, the new city would have insufficient reserves to cover any revenue shortfalls. In essence, the CFA relies on projections of the absolute minimum levels required for viability without sufficient basis to do so. CFA at 4, 13, 40.

The City further states for clarification:

> [The CFA makes the following assumptions: 1) mandatory service cuts 2) no fluctuation in projected revenues. Will these assumptions lead to financially sound reserve levels as compared to cities of similar size referenced in Moody's report? The phrase "realistic assumptions" may be replaced with "logical or financially sound assumptions."]

State Controller's Office Analysis and Response to City Concern 3:
The State Controller's Office determined that no separate research was conducted by LAFCO to determine the level and source of proposed service reductions mentioned in the CFA. In addition, the CFA does not discuss what services will be changed or how the reductions will be accomplished or whether it is even possible to make such reductions. In addition, the City is correct in its assessment that in the absence of a $10 million loan to the proposed Hollywood city by the City of Los Angeles and a $10 million reduction in services, the new Hollywood city would have insufficient reserves to cover any revenue shortfalls.

As noted in the State Controller's Office response to ISSUE 1, City Concern 1, the proposed loan and service reduction should have been categorized as a proposal to address the negative reserves of the new Hollywood city. Without them, the positive reserve levels noted in all three boundary proposals would be negative.

City Concern 4

The City expressed its fourth concern as follows:

> The CFA has not addressed the shortfall the new city would experience that results from the proposed operating costs exceeding available discretionary funds. The CFA states the new city would need to spend $1.7 million to cover expenditures on staff and other operating costs and would have available 0.6% of its revenues available for discretionary purposes. CFA at 40. However, 0.6% would not cover operating costs as shown in the following table:

	Operating costs	Discretionary funds needed (0.6% of revenues)	Shortfall
SRA 1	$1.7 million	$1.3 million	$400,000
SRA 2	$1.7 million	$750,000	$948,000
SRA 3	$1.7 million	$1 million	$642,000

State Controller's Office Analysis and Response to City Concern 4: The State Controller's Office determined that the new Hollywood city will incur an additional $1.7 million in personnel and facilities costs for its own operations and $385,000 in annual contract administration costs. Therefore, the City has understated the total annual operating costs. These costs exceed the additional vehicle license fee and gas tax revenue the new Hollywood city will receive. As noted under CITY ISSUE 1, Concern 1, the CFA incorrectly assumed that a $10 million loan and a $10 million service reduction would address this shortfall.

City Concern 5

The City expressed its fifth concern as follows:

> The CFA contains inaccurate election and contract administration costs and does not appear to account for repayment to the City of all transition costs (costs incurred by the City as a result of the special reorganization). CFA at 24, 45-48.

State Controller's Office Analysis and Response to City Concern 5: The State Controller's Office determined that the CFA has understated contract administration and transition costs by $2.03 million for SRA 1, $2.19 million for SRA 2, and $2.08 million for SRA 3. In addition, the State Controller's Office concluded that the CFA was correct when it did not include election costs for a special council election.

Election Costs: The State Controller's Office has determined that the CFA's exclusion of costs for a special election is correct. The proposed new Hollywood city lies within portions of Council Districts 2, 4, 5, and 13 under each SRA scenario. If secession occurs, portions of each of these districts would remain as part of the City of Los Angeles. The City contends that a special election would be required for each of these districts and that the costs should be identified and mitigated. However, a special election for Council Districts 2, 4, 5, and 13 will not be required because the current Council Members who represent these districts do not reside in any of the proposed new Hollywood secession areas and could continue to represent their districts without a special election. In addition, the City is currently in the process of redistricting its council districts and the CFA includes an additional $500,000 for redistricting costs if the proposed new Hollywood city secedes. Consequently, election costs and related campaign matching funds are not understated.

Contract Administration: The State Controller's Office determined that the City's estimate of annual contract administration costs of between 1.16% and 2.04% of the service contract depending on the boundary alternative, is more accurate than the CFA's estimate of 0.2%. While these percentages are relatively small, they represent between $1.85 million and $2.02 million in additional costs that the new Hollywood city will have to absorb, and which would further increase the negative level of general fund reserves.

The City provided a schedule which concludes that the CFA has understated annual contract administration costs by between approximately $1.85 million and $2.02 million. The City has identified 14 departments with an estimated annual contract administration cost of $2.24 million, or between approximately 1.16% and 2.04% of the estimated service contract cost. The City provided documentation to substantiate the schedule and methodology. Therefore, the City's estimate of annual contract administration costs appears to be a more accurate estimate of costs. This item further adversely impacts the projected level of negative reserves noted in ISSUE 1, City Concern 1.

The City's one-time contract administration cost appears to be primarily an information systems issue, because 98% ($16 million) of the one-time contract negotiation cost occurs in the Information Technology Department. The Information Technology Department manager believes that administering the contract to provide services to the new Hollywood city will require complex negotiations of each of 147 systems that have been defined as "critical." The department manager estimates that each negotiation will require a three-person team working four months: 147 person-years in total. The City's position is that each "critical" system application will require a separate contract.

The State Controller's Office has concluded that, while some one-time contract administration costs may be possible, the estimate of the potential costs of the Information Technology Department seems unreasonable. Many of the "critical" systems are not related to either contract administration or new Hollywood city services. For example, the list of "critical" systems includes the scheduling system in the Mayor's Office, a system for printing mailing labels, a system for tracking Savings Bond purchases, and a system that tracks property assessments for City expenses in maintaining the Wilmington Cemetery, located in the Harbor area.

Also, the City provided no justification to support why each critical system would require a separate contract or explain why each contract would require a person-year to negotiate, except to state that it was based upon past experience.

Transition Costs: The State Controller's Office concludes that the City's $1,175,000 estimate of transition costs for redistricting, closing books, validating pre-existing bonds, and establishing revenue collection procedures is appropriate. However, the State Controller's Office also determined that the CFA contains $1 million for redistricting costs alone. Therefore, the transition costs are understated by $175,000. This item further adversely impacts the projected level of negative reserves noted in ISSUE 1, City Concern 1.

Transition costs also appear to be primarily a systems issue, because the Information Technology Department is requesting $30 million to "assess" changes that might be required to transition the provision of services from the City to the new Hollywood city.

However, the CFA assumes that other agencies, primarily the City, will provide all services during the period covered by the CFA. Therefore, the transition costs discussed by the City do not need to be included in the CFA. While there will inevitably be some transition costs as the new Hollywood city assumes direct service provision after the period covered by the CFA, both the City and the new Hollywood city will need to consider those costs at that time.

City Concern 6

The City expressed its sixth concern as follows:

> The CFA incorrectly represents contract administration costs as a function of the size of the new city and not workload. Contract administration costs will be determined by such factors as: the complement of services to be provided, the level of detail requested, and the frequency of billing requirements. These are workload functions that do not change based on the size of the population being served. CFA at 17.

State Controller's Office Analysis and Response to City Concern 6: The State Controller's Office concludes that the CFA determined contract administration costs as a function of the size of the service contract (workload) and not as a function of the population being served (size of the new city). Therefore, the City's concern was appropriately addressed in the CFA.

City Concern 7

The City expressed its seventh concern as follows:

> The CFA fails sufficiently to account for start-up costs (additional costs the new city would incur as a result of the special reorganization). CFA at 16-24.

State Controller's Office Analysis and Response to City Concern 7: The State Controller's Office concludes that the one-time start-up costs for the new Hollywood city's operations included in the CFA are appropriate because the preponderance of the new Hollywood city's services will continue to be provided by the City during the period covered by the CFA.

City Concern 8

The City expressed its eighth concern as follows:

> Insufficient detail has been provided regarding the allocations of revenues and expenditures used by LAFCO in their analysis for each proposed boundary.

State Controller's Office Analysis and Response to City Concern 8: The State Controller's Office concludes that the CFA provides sufficient detail to determine the revenue and expenditures for each of the proposed boundaries. Furthermore, the methodology used in the CFA for this allocation is reasonable.

The CFA determined direct service levels attributable to each new Hollywood city area through a review of departmental organizational charts and the City's budget for fiscal year 2000-01. The CFA determined the staffing levels for both direct and indirect services based upon the positions on the organization charts, reconciled to the approved positions in the budget. The methodology used in the CFA is appropriate.

The CFA determined direct service costs by considering the staff physically located or directly assigned to Hollywood locations. Indirect service staff performs support and headquarters functions that are not easily or physically associated with a geographic area. The CFA calculated Hollywood's proportion by dividing the personnel in Hollywood by the personnel Citywide for a service function. The resulting percentage was multiplied by the City's total indirect staffing (and budget) level from all City departments to determine the new Hollywood city's indirect staffing (and budget) level. The methodology used in the CFA is appropriate.

The CFA determined revenue levels for the various new Hollywood city special reorganization areas using a combination of information provided by the City and geographic locations. The CFA used statistical information for fiscal year 1998-99 (the latest year available) to determine the source of revenue (i.e., taxes and fees) by address. The CFA developed a percentage by comparing information obtained (e.g., sales tax activity) for each SRA to the same information for the current City. The CFA determined the share of revenue attributable to that area of the new Hollywood city by applying the percentage developed in the sample to the revenue or fee for fiscal year 2000-01. The CFA used this methodology to project total revenue.

State Controller's Office Conclusion Regarding City ISSUE 1:

The State Controller's Office has determined that there is no authoritative basis for determining a "sound financial management" level of reserves. However, the State Controller's Office has also determined that the CFA has incorrectly determined that the new Hollywood city would have positive general fund balances. The CFA adds a $10 million loan and a $10 million service reduction to the calculation of reserves to make them positive rather than showing them as alternatives to address the negative reserve balance in all boundary alternatives proposed for the new Hollywood city. For the boundary alternative recommended in the CFA, excluding the loan

and service reduction, the negative reserves would be between 6.24% and 17.52%.

This lack of positive reserves raises a serious concern regarding the fiscal viability of the proposed new Hollywood city. In addition, several cost items in the CFA were calculated incorrectly, and could further increase the level of negative reserves.

Finally, the CFA indicates that reserves will grow and compound each year. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA which indicates that the reserves for the new Hollywood city will increase is unreliable.

CITY ISSUE 2

The City raised the following issue in its request to LAFCO:

"Does the CFA adequately assess the fiscal impact on the City of Los Angeles?"

The City stated the following:

> Cortese-Knox-Hertzberg requires that a CFA study the "effects on the costs and revenues" of any affected agency. The remaining City would be an affected agency. The special reorganization process requires that the remaining City not be subjected to financial harm. The need to raise revenues and/or cut service levels to the residents and businesses in the remaining City are the most obvious forms of financial harm.

The City identifies four concerns to support its conclusion. These concerns are:

> **City Concern 1**: The CFA does not address the cumulative effects on the remaining City if all three areas (San Fernando Valley, Harbor, and Hollywood) detach simultaneously.
>
> **City Concern 2**: The CFA finds that the City would immediately lose $4.1 million to $5 million in documentary transfer tax. The CFA states that the tax reduction is not assumed to impact the mitigation payment to the City.
>
> **City Concern 3**: Some of the formulae used in the CFA for allocation of debt change the existing debt burden.

City Concern 4: The CFA applies the *Gonzalves* rule during the transition period prior to the existence of a contract. The City believes that the *Gonzalves* rule should not apply to a special reorganization.

ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 2

City Concern 1

The City expressed its first concern as follows:

> The CFA does not address the cumulative effects on the remaining City if all three areas (San Fernando Valley, Harbor, and Hollywood) detach simultaneously.

State Controller's Office Analysis and Response to City Concern 1: The City was unable to identify what effects other than those in the three CFAs would be included in the "cumulative effects." In addition, each of the three CFAs assume that services would continue to be provided by the City during the entire period of the CFAs. Therefore, there should be no discernible impact on the City other than those already described in the CFAs or the Controller's reports responding to questions about the CFAs.

City Concern 2

The City expressed its second concern as follows:

> The CFA finds that the City would immediately lose $4.1 million to $5 million in documentary transfer tax, depending on the boundary alternative, as a result of the special reorganization. The CFA further states that the tax reduction is not assumed to impact the amount of the mitigation payment made to the City. This assumption results in an uncompensated fiscal harm to be borne by the remaining City.

State Controller's Office Analysis and Response to City Concern 2: The State Controller's Office has determined that the CFA has correctly addressed the documentary transfer tax issue. As noted under ISSUE 1, City Concern 2, the proposed new Hollywood city will receive less revenue from this tax than the City currently does. However, the City will only be mitigated for the amount of revenue the new Hollywood city will receive—not the amount it will lose.

City Concern 3

The City expressed its third concern as follows:

> Some of the formulae used in the CFA for allocation of debt change the existing debt burden. This change is unfair because the debt was incurred in reliance on revenue streams that included those coming from the Hollywood area. A result of this change is a reduction in the level of debt service to be received from the Hollywood area by the remaining City. App II at 161-165; CFA E Tables.

State Controller's Office Analysis and Response to City Concern 3:
The State Controller's Office concludes that the CFA's methodology of allocating bond debt based upon the number of employees does **not** produce an accurate and reliable result. It understates costs associated with bond debt by $3.7 million to $5.8 million per year.

The CFA notes that the City does not retain records that identify the location of many of the assets financed with lease obligation bonds and certificates of participation. In instances where the City was able to identify the location of the asset financed with lease obligation bonds and certificates of participation, the debt was allocated based upon asset location. In instances where the City could not identify the location of the asset, LAFCO based its allocation on the number of employees assumed to serve the new Hollywood city area as a percentage of total City employees.

In other documentation provided by the City, the City stated that debt to be repaid with general fund monies should be allocated based upon the loss of general fund monies by the City. Under this position, using the percentage of general fund revenue allocated to the new Hollywood city, the new Hollywood city would be responsible for between 3.7% and 6.3% of the general fund debt depending upon the special reorganization area. The City's recommended methodology would appear to produce a more accurate result.

The CFA estimated that the new Hollywood city would be responsible for between $7.3 million and $13.0 million in general fund funded bonded debt, depending upon the special reorganization area. Under the City proposal, this share would increase to between $11.0 million and $18.8 million.

City Concern 4

The City expressed its fourth concern as follows:

> The CFA applies the *Gonzalves* rule during the transition period prior to the existence of a contract. The *Gonzalves* rule specifically prohibits counties from charging indirect costs to newly detached cities contracting back with the county for services. The City believes the *Gonzalves* rule should not apply to a special reorganization and the County Counsel has preliminary indicated that the *Gonzalves* rule will not be applied to the Hollywood special reorganization. CFA at 6.

State Controller's Office Analysis and Response to City Concern 4: The State Controller's Office concludes that the *Gonzalves* rule, contained in *Government Code* Section 51350, should not be applied during the period covered by the CFA. *Government Code* Section 51350 prohibits a county from charging general overhead costs of operation of the county government when providing services under contract to a city. The CFA assumes that this code section will be applied during the transition period to the City when providing services to the new Hollywood city. The result is that costs to the new Hollywood city are understated by an additional $611,500 to $1.04 million in expenditures during the transition period, depending upon the boundary proposal selected. This will increase the level of negative reserves for the new Hollywood city by increasing the reimbursement to the City by these amounts.

State Controller's Office Conclusion Regarding City ISSUE 2:

The State Controller's Office determined that the negative general fund reserve level of the proposed Hollywood city would be increased because of the misapplication of the *Gonsalves* rule. This rule prohibits a county from charging general overhead costs of operation of the county government when providing services under contract to a city. The CFA incorrectly assumed that this rule would apply to charges by the City of Los Angeles for services provided to the new Hollywood city.

CITY ISSUE 3

The City raised the following issue in its request to LAFCO:

> **"Does the CFA accurately address the impact on other agencies, such as Los Angeles Unified School District ('LAUSD'), Los Angeles Community College District ('LACCD') and the County of Los Angeles?"**

The City states the following:

> The fiscal impact on other affected agencies should be analyzed in the CFA, as required by Cortese-Knox-Hertzberg. Government Code § 56014 defines an affected local agency as "any agency which contains, or would contain, or whose sphere of influence contains any territory with any proposal or study to be reviewed by the commission." The City conducts elections on behalf of LAUSD (pursuant to Resolution). Both LAUSD and LACCD share territory with the City, and based on Government Code, qualify as "affected local agencies." As part of the regular municipal election process, these agencies share election costs with the City.

The City identified two concerns to support its position that fiscal impacts to local agencies were not addressed. These concerns are:

> **City Concern 1**: The CFA does not consider the potential impact on LAUSD, LACCD, and the remaining City.
>
> **City Concern 2**: The CFA does not appear to account for the decrease in revenues caused by the loss of a portion of documentary transfer tax.

ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 3

City Concern 1

The City expressed its first concern as follows:

> The CFA does not consider the potential impact on LAUSD, LACCD, and the remaining City. The timing of this matter will necessitate that the City Clerk seek, through court action, to delay the March 2003 municipal elections to allow for sufficient time for redistricting and candidate filing. The election costs borne by all three agencies may be affected if LAUSD and LACCD are unable to delay their elections to accommodate our revised schedule.

State Controller's Office Analysis and Response to City Concern 1: The State Controller's Office concludes that the CFA does not note an impact to the LAUSD or the LACCD. *Government Code* Sections 56036 and 56054 specifically exclude school and community college districts from the definition of special districts that are affected local agencies. The concern regarding impact to the City is addressed as part of the State Controller's Office response to ISSUE 1, City Concern 5.

City Concern 2

The City expressed its second concern as follows:

> The CFA does not appear to account for the decrease in revenues caused by the loss of a portion of documentary transfer tax, which impacts both the City and County of Los Angeles.

State Controller's Office Analysis and Response to City Concern 2: This concern was addressed as part of the State Controller's Office response to ISSUE 1, City Concern 2.

State Controller's Office Conclusion Regarding City ISSUE 3:

The State Controller's Office concludes that the CFA did not address the fiscal impact of the proposed new Hollywood city on either the Los Angeles Unified School District or the Los Angeles Community College District. However, it was not required to do so.

CITY ISSUE 4

The City raised the following issue in its request to LAFCO:

"Does the CFA calculation of revenue neutrality accurately reflect the fiscal impacts the City will realize at the end of the transition or service contract period?"

The City identifies only one concern as follows:

City Concern 1

> It is requested that the discussion provided in the letter dated February 11, 2002 requesting State Controller review of the San Fernando Valley CFA be incorporated herein by reference.

The City previously stated that concern as follows:

> The CFA's calculation of revenue neutrality does not reflect the cost impacts to the City after the end of the transition or service contract period. The CFA evidently pegged revenue neutrality at $65.8 million by deducting the City's budgeted expenditures for services that would be paid by the Valley city through a service contract with the City (i.e., the cost of purchased services) from revenues that would accrue to a Valley city (i.e., revenues lost to the City). The City has voiced objection to LAFCO concerning this approach on several previous occasions. See, e.g., letter of June 7, 2000 from Fredrick N. Merkin of the City Attorney's Office to Assistant County Counsel John F. Krattli. The City believes that the correct approach required an assessment of the savings the City would enjoy by not having to service the Valley. In the City's view, these cost savings should then be deducted from lost revenue to yield the mitigation payment (or other lawful form of mitigation) required by the revenue neutrality law. These savings will be much less than the projected cost of purchased services, because the City will need to maintain many centralized and non-divisible services (resulting in 'stranded costs') in order to continue the same service level of service to the residents of the remaining City post- secession. While the question of what methodology Cortese-Knox requires to calculate revenue neutrality is a legal one to be resolved, if at all, in the courts, this request asks only that the Controller review and confirm that the CFA's calculation of revenue neutrality did not take these costs into account.
>
> The CFA noted the City's contention that certain municipal functions are not divisible, that secession would not result in a reduced workload for certain City personnel, and that new personnel would have to be hired to maintain the same level of service for the remaining City. The CFA observed that with a reduction in the City's population of over 36% (more than 1.3 million people), with certain noted exceptions ' the remaining workload confronting City departments would decrease significantly across the range of municipal operations.' According to the CFA, to make its case, the City would need to produce data demonstrating the absence of workload reduction. The CFA went on to state that since these data had not been supplied, 'it is difficult to substantiate the argument that the City's workload would

not decrease.' Yet, in the end the CFA asserts that it avoids the problem raised by the City because of the service contract model studied. According to that approach, few, if any, City employees would be transferred to the Valley city, as the City would continue to render virtually all services to the Valley. Hence, the City would not be required to hire additional personnel. CFA App I at 10-22; App II Cost of Purchase Services; CFA E Tables. The result of such an approach is to ignore the substantial fiscal impacts that the City of Los Angeles will realize at the end of the transition period or termination of any service contracts, when the City is no longer compensated for centralized and non-divisible costs through contract payments from the Valley, and these costs become stranded. Absent mitigation, the proposal under study would push the remaining City of a financial cliff at this point. The CFA approach also fails to address the need for that impact to be mitigated by a revenue neutrality payment (or other lawful form of mitigation) in order to preserve existing service levels in the remaining City.

The Controller is requested to confirm only that: the description above accurately reflects how the CFA went about calculating revenue neutrality. Whether this was the correct methodology is a different question altogether. Whatever methodology is to be applied constitutes a derivative of the interpretation of the revenue neutrality law. Disputes over that interpretation must be resolved, if they are to be resolved, in the courts. This issue's low placement on the City's priority list should not be seen as a reflection of the City's belief in the relative unimportance of the issue. On the contrary – the revenue neutrality methodology to be applied here represents an issue of prime importance to the City. The City has placed this issue here because it clearly turns on the interpretation of a statute.

State Controller's Office Review and Analysis of City Concern 1: The State Controller's Office concludes that the CFA has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.

However, *Government Code* Section 56815 validates the CFA's methodology to base mitigation payments solely on the difference between current revenue and current expenditures. Therefore, the CFA is not required to reflect cost impacts the City may realize at the end of the period covered by the CFA.

State Controller's Office Conclusion to City ISSUE 4:

The State Controller's Office determined that the City of Los Angeles has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.

State Controller

Kathleen Connell

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